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Unemployment duration and the interactions between unemployment insurance and social assistance

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Abstract

Existing studies suggest that reforms that reduce the generosity of the unemployment benefits should lower unemployment. Despite the large number of such reforms implemented in Europe in the past decades, evidence from various data sources shows very little correlation with the evolution of unemployment. This paper suggests that the scant success of these labour market reforms can be explained by the interactions between unemployment insurance and other social assistance programmes. Evidence from the European Community Household Panel shows that recipients of unemployment insurance who are also eligible for other welfare schemes are indeed less sensitive to changes in the level and the duration of their benefits.

JEL classification: J64; J65
Keywords: Unemployment duration; Unemployment insurance; Social assistance; Duration models

1. Introduction

Many studies have already explored the effects of unemployment insurance (UI) on the duration of unemployment (Atkinson and Micklewright, 1991). Two empirical findings are now widely accepted. First, as initially showed by Nickell (1979) and Lancaster (1979), higher benefits are associated with longer unemployment spells. Later, Moffitt (1985) and Meyer (1990), having access to information about both the level and the duration of benefit entitlement at the individual level, showed that the probability of exiting unemployment increases around the time of benefit exhaustion.

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The literature also provides a comprehensive theoretical framework for interpreting these results. Mortensen (1977) develops a simple search model that easily delivers negative correlation between exit rates and unemployment benefits via search effort and reservation wages being respectively negatively and positively affected by income out of work. When UI entitlement expires, income out of work drops, inducing an increase in search effort and a decrease in the reservation wage, thus providing an explanation for the observed higher exits rates around the time of exhaustion. Cahuc and Lehmann (2000) recently extended the model by endogenising wages and allowing the unemployment benefit to gradually decline over time.

On the basis of these findings, one would expect reforms that reduce either the level or the duration of unemployment benefits to have a positive impact on the unemployment rate. However, this prediction does not seem to conform with the recent experience of many European countries. Fig. 1 plots the time series of the unemployment rate for selected European countries. The vertical lines indicate the implementation years of reforms that have modified either the level or the duration of the unemployment benefits. The solid bars refer to changes in the amount of the benefits and the dashed lines to changes in their duration. The thickness of the lines indicates the direction of the reform: thick for reductions (either in the amount or duration of benefits) and thin for increases.

A first simple fact is evident from Fig. 1: the past 20 years have been constellated by labour market reforms in virtually all European countries (also the ones not shown in the figure). Moreover, despite the coexistence in many countries of reforms of opposite sign, often implemented close to each other (in Finland and France, for example), most of the changes (19 out of 29 in all the 15 pre-enlargement EU countries) modified the system towards less generous benefits paid for a shorter time. However, already a simple visual inspection of Fig. 1 suggests that the correlation between these reforms and the evolution of unemployment is rather weak and it does not improve even when controlling for the business cycle.

More convincing evidence can be produced for those countries where reforms took place during the years covered by the European Community Household Panel (ECHP)[1], namely between 1994 and 2001. This is possible for six countries: Austria, Belgium, Finland, Germany, Ireland and the United Kingdom. Table 1 shows the conditional difference in the probability of finding employment between individuals who entered unemployment before and after the reform. The estimates are produced with a standard hazard model controlling for gender, age, health status, education, marital status, family size, presence of children, household income, regional unemployment and year dummies.[2]

Results confirm the visual impression from Fig. 1: reforms that reduced the generosity of the UI system did not have a significant effect on the probability of finding a job. There are marginally significant effects only in Austria (where the estimate is actually negative) and Ireland. The scant success of labour market reforms in Europe has been acknowledged by other authors as well, for example Coe and Snower (1997), Elmeskov et al. (1998), Orszag and Snower (1999), Nickell and van Ours (2000).

This paper suggests an explanation for the failure of so many reforms of the unemployment compensation system. All European countries have complex welfare states and unemployment compensation is only one element of the system that necessarily interacts in various ways with all the other programmes. In particular, many unemployed persons receive other social assistance benefits together with their unemployment insurance.

[1] The data are described in details in Section 4.
[2] A fuller description of the econometric model is provided in Section 6.